The 412(i) Fully Insured Defined Benefit Pension Plan for the Small Business

A type of defined benefit plan exists that is a very viable plan design for the "right" small business situation. What follows is a general description of this plan and a discussion to help identify the right type of situation where this plan will have appeal. The plan is called the 412(i) defined benefit plan, It is also referred to as an insurance contract plan. It will be referred to here by its third common name, the fully insured defined benefit plan.

This discussion will focus on the problems created by legislation for the traditional defined benefit plan and why the fully insured defined benefit alternative offers a solution to many of these problems. The fully insured approach is not for everyone, but small businesses with very few employees should be aware of this alternative. It can produce appealing results and solve some big problems in the right situation.

Generally, the fully insured plan would have the most appeal in a business with five or fewer employees where the owner is age 50 or older. The business should have a steady cash flow. The best situation is one in which there has been no previous plan in existence. Establishing a new fully insured plan can mean substantial deductions for the business and meaningful retirement benefits for the participants.

Over-funding and Over-regulation of Traditional Defined Benefit Plans

Many existing traditional defined benefit plans may have become over-funded due to tax law changes in the last few years. In some situations, conversion to a fully insured plan may restore deductible contributions to the plan and eliminate penalties for reversion of excess assets upon plan termination.

Fully insured defined benefit plans are not a recent innovation, so why should this approach warrant closer consideration today? The reason is related to what might be termed "over-regulation" of the traditional defined benefit plan in the small business. The Employee Retirement Income Security Act of 1974 began an era of massive regulation of retirement plans. Originally, the goal was to end abuses in the funding of plans and to more adequately secure the rights and benefits of plan participants. Through the years, much of the regulation has seemed to be directed more at raising revenues than curbing abuses. At any rate, the end result of years of changing the rules for defined benefit plans, limiting benefits, cutting deductions, and attacking plan actuarial assumptions, has served to add confusion and complexity, and has increased administrative costs for the small business. The knockout punch for defined benefit plans came with the passage of the Omnibus Budget Reconciliation Act of 1987 (OBRA '87). The changes for defined benefit plans mandated by this Act have caused many small businesses to re-think the viability of the defined benefit plan. These changes will be discussed below, along with the reasons why the fully insured plan counters most of the problem areas.

Specifically, OBRA '87 contained mandates for defined benefit plans which included:

- quarterly contribution requirements with penalties for the improper amount or timing of the contributions.
- penalties on the reversion of excess assets to the employer at plan termination
- a new full funding limit substantially reducing or completely eliminating deductions in some situations; and
- new mandates that each actuarial assumption be reasonable standing alone and no longer reasonable "in the aggregate."

Since these and other complex, confusing, and limiting factors for defined benefit plans are contained in IRC Sec. 412, the solution is to utilize a plan that is exempt from the funding requirements of IRC Sec. 412. If a plan meets the requirements of IRC Sec. 412 (i), it will be exempt from the section's funding rules. For this reason, the 412(i) or fully insured plan deserves a closer look.